Audit's® NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

# Realty Trust Review

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SPECIAL SITUATIONS AND GROUP REVIEW ISSUE



## SPECIAL SITUATIONS: PLAYING THE OLD WINE EMERGING IN NEW BOTTLES FROM WORKOUTS

It's time to start looking seriously at the new securities now coming to market as result of workouts and bankruptcy reorganizations. We call them old wine because they are essentially backed by the assets and managements of a well-known realty trust, yet are in the new bottle of a new security.

That new bottle generally is a security with terms at or near today's market, in interest rate, conversion or exercise price, or other terms.

But some new bottles have broken already. Example: Chase Manhattan Mtg. & Rlty. offered an 11-5/8% debenture convertible at 2¼ during a 1977 workout attempt. Despite success at that time, the trust subsequently was forced into Ch. XI bankruptcy filing Feb. 22 to gain protection from creditors, a move that effectively sends the 11-5/8s back into the winepress for rebottling.

That's one reason we've been standoffish on these new-old securities: A successful tender/exchange offer doesn't necessarily mean success in the long-run.

So far the restructuring of the realty trusts has gone pretty much along the lines of the railroad industry's workouts of the 1930s, with some significant differences. First, fewer trusts have hit the bankruptcy courts. So far an even dozen trusts (p. 2) have sought court protection from creditors, and some of those have been filed to ratify a plan previously worked out and approved by creditors. Thus the average trust bankruptcy stay has been fairly brief, compared to some marathon railroad bankruptcies of the 1930s.

Second, bank and other lenders to realty trusts have acted with greater



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creativity and restraint than in the 1930s. Gone is the almost uniform approach of converting most debt into income bonds (i.e., bonds paying interest only if and when earned). Banks and indenture trustees for bond issues haven't thrown realty trusts into bankruptcy at the drop of a hat but have let trusts work out solutions suiting the peculiar characteristics of their assets. This has led to proliferation of new securities of many different types.

Here are the two basic things you should look for in considering these new-old securities, in our opinion:

1. Is the trust really out of trouble? If the workout doesn't completely cure a problem, or doesn't give the trust a good shot at working out of its hole, you will be wasting time in looking at the new security, let alone putting your hard-earned money on the line. Very often this is a judgment call, where intangibles can come into play that aren't readily apparent.

For instance, we and most other Wall Streeters mis-read the Chase Manhattan Mtg. & Rlty. 11-5/8% subordinated debentures when they were exchanged for other Chase debentures in August 1977. Prior support of sponsor and adviser Chase Manhattan Bank led nearly everyone to believe that that major money center bank would protect its reputation by providing additional aid should the workout plan falter. Alas, the bank decided it wouldn't pour anymore money into the situation and let the trust default on a May 1, 1978 maturity of $37½ million of 7-7/8% senior notes. When complex creditor negotiations stalled, CMR sought Ch. XI protection on Feb. 22.

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TRUST BANKRUPTCIES

These seven trusts are currently in Chapter proceedings: Chase Man. Mtg., Citizens Mtg., Continental Mtg., Dominion Mtg., Guardian Mtg., Metroplex Rlty., and NJB Prime Inv. Five others have been discharged: Associated Mtg., Colwell Mtg., Great Amer. Mgmt. & Inv., Lifetime Communities (was Fidelity Mtg.), and National Mtg. Fund.

We, along with many other investors, advisers and brokers thus are always dealing in the realm of the expectable and doable in assessing these securities for you. Often we have to fall back on gut feeling and instinct instead of factual analysis and proven track record. If you choose to operate in this area, you must recognize both the presence and importance of these intangibles and accept our suggestions for what they are: Informed opinions in an area where the situation can change within minutes.

2. Does the new security have any upside? Frankly we're not much interested in old wine in new bottles unless we can see some worthwhile kick. If the new security merely stretches debt but has no realistic equity kicker, then generally we'll avoid it unless the yield is super.

But here we take the optimistic and opportunistic view that some of this kick can come from intangibles. Some trusts, for instance, hold properties suitable only for liquidation over the longer term. We see them, realistically we hope, more as empty glasses of water into which a creative management may pour new business lines to use taxloss carryforwards, or as acquisition candidates.

But again, these are judgment calls that often depend upon management's creativity in seeking and exploiting new business opportunities, or in our perception of what management can (or is willing to) do with the situation at hand. Like a game of golf, management must play the ball where it lies. Again, you must understand this judgment component in our recommendations.

Here, then, is a look at some of the opportunities we see in new securities emerging from realty trust workouts so far. They are discussed here in overview and you should consult the Feb. 9 Relative Appeal Ranking issue for factual details. One further caution: Many workout securities are thinly traded and transaction prices may vary widely from those quoted. Bonds, especially, are often "workouts," meaning you will have to negotiate with-

in very wide spreads. Some may not be maginable, except through special arrangement with your own bank (i.e., not through your regular broker).

We see these new-old securities breaking into three large categories:

Attractive speculations, where both fundamentals and intangibles seem to hold promise of good returns.

Moderately interesting, mainly nonconvertible bonds that may have fairly high income and intermediate-term maturities.

Crap shoots, the outright gambles with no present way to predict outcome and no real investment merit. They're suitable for "mad money" only but often are the most rewarding.

ATTRACTIVE SPECULATIONS

Compass Investment Group 8¼% convertibles due 1998 were recently quoted 96-100 to yield 8.2%. The play here is two-fold: First is convertible play at today's market: Conversion price was adjusted downward on Dec. 1, 1978 under a pre-determined formula from $31 to $1.35/sh. That makes a $1,000 bond worth 740.74 sh. Bonds are quoted essentially at conversion parity with the stock posted at 1-3/16 bid. But there's no volume at that price and many buyers at 105 and higher are unwilling to sell. Point is that you will have to negotiate for any volume to take advantage of the convertible play.

Second is a merger play. Late in December two California holders, Joe Akerman and John Wertin, converted about $1.7 million of the debentures into 1,514,711 sh. or 48.7% of shares. Wertin, Akerman and associates are expected to be elected to the board at the Mar. 30 annual meeting, in effect giving Akerman and Wertin control.

Akerman is a former REIT analyst for a San Francisco brokerage firm and Wertin is a growing residential builder based in Irvine, Cal. It's widely expected that John Wertin Development Corp. or some other company will be merged into Compass to produce earnings that could use Compass' $23.6 million taxloss carryforward.

Estimating the upside is difficult because of the large potential dilution (the remaining $16.4 million of 8¼s could convert into another 12,175,000 sh., compared to about 3.06 million shares out at Dec. 31, 1978). Moreover, overhanging conversion at $1.35 would pull down the Dec. book value of about $4.00/sh. to about $1.87/sh. on a fully diluted basis, assuming no additional earnings. That puts a 138½ stock value on the bond today selling near par. More importantly, there's a very real possibility that Compass may in time be viewed as something of a growth homebuilding company, in which case it's possible most of that taxloss, equal to another $1.55 fully diluted share, could be added back to book value. This would give the bond about a 250 stock value, again disregarding additional earnings.

On the downside, we think danger of default of interest on the bonds is remote. Compass has already repaid all bank debt and the 1998 maturity is distant enough to provide working room for the situation to mature. Part of past-due interest on the 8¼s was paid in January and additional payments depend upon cash flow; the debentures thus remain in default and carry $148.50 accrued unpaid interest. All this makes the 8¼s an attractive speculation.

Tri-South Mortgage Investors 10s of 1988 were exchanged for a good part of TSMI's other two bonds in mid-1978. What emerged was a senior note with realistic conversion at $2.50/sh. Again, the bonds are quoted with a wide spread of 105-110 or essentially at conversion value with the stock selling about 2-3/4 to 3. Essentially the converts are expected to continue selling at about conversion value.

TSMI shares have about $3.59/sh. book value at end of 1978, so that conversion of the 10s would reduce book value to about $3.03/sh. on a pro forma basis.

Unlike Compass, Tri-South must solve some liability problems. It has now cut bank debt to $8 million and must repay another $2.6 million by June 30 in order to receive forgiveness of $3.4 million or a-

bout \$1.50/sh. accrued and unpaid interest. Management is confident that all bank debt can be repaid by Dec. 31, 1978 maturity.

That leaves the trust facing Feb. 15, 1980 maturity of \$11.4 million of its 7-3/4% subordinated debentures. It's not likely, in our judgment, that the trust can raise enough money by selling assets to repay both bank debt and the subordinated debt within the 11 months remaining. That means Tri-South likely will come down to the Feb. 15, 1980 deadline in much the same deadheat atmosphere with which North American Mtg. is confronting a March 15 maturity for \$16.2 million of 5½% debentures. (The NAMI situation is complicated by fact that it still owes \$33 million to its banks, whereas Tri-South should be out of the banks by next year.)

To honor these debts Tri-South ended 1978 with \$75 million invested assets, divided 38% mortgage loans; 31% nonoperating properties (land, condos, etc.) held for resale; 16% operating properties held for resale; and 15% operating properties held for investment. The trick will be to retain as much of the investment property as possible while raising funds to meet these maturities.

There are two time-honored ways of dealing with such high-risk situations: buy the lowest-rated debt, and buy the highest rated debt. The lowest-rated and hence riskiest debt (e.g., TSMI's 7-3/4s) has advantage of being in control of the situation, since management must deal with the looming near-term maturity. If Tri-South isn't able to raise enough cash to repay these bonds in cash at maturity, then realistically the management will have to offer some attractive alternative -- possibly offering to convert some or all of this debt into equity. So the 7-3/4s are a viable and potentially rewarding way to play the TSMI situation. With the bonds selling at 90 on the NYSE, repayment in less than a year would theoretically yield about 17½%. The risk would be that the trust couldn't pay on time, in which event the bonds likely would fall sharply in market price.

It's this risk that makes us prefer the 10s of 1988. The 10s have already gone through the workout wringer and offer a realistic conversion price, one that isn't likely to be bettered even in the unlikely event that the trust would be forced into bankruptcy. Moreover, they are senior to all other debt and, if and when bank debt is repaid by end of 1979, they would rank ahead of all other debt. So if TSMI were to be forced into bankruptcy, you would have first call on assets.

Mind you, we don't expect default or bankruptcy in the Tri-South situation, but we do think you have to weigh it as the worst-case alternative. And that's why we favor the 10s, at a price of 105-110, as the best vehicle here.

## MODERATELY ATTRACTIVE SPECULATIONS

We put a number of bonds with equity features, plus a few straight bonds, warrants and stocks into this category. Comments on these situations:

Citizens & Southern Rlty. Series B warrants were issued in Oct. 1977 in exchange for old Series A warrants that had been exercisable at 80% of market price during Sept. 1977. When that price could not be determined easily because of unstable market conditions, trustees offered to exchange the new Series B warrant, exercisable at \$2/sh., for the old Series A; about 86% of holders accepted the exchange so that about 258,000 warrants are now outstanding.

The Ser. B warrant gives holders the right to purchase 50 shares for \$100 cash or face amount of new 3%-7% debentures anytime before Mar. 31, 1983. The warrants are quoted at about \$8 in over-the-counter trading, so that the conversion premium of 73% over the direct purchase of the stock (1¼-NYSE) is quite large.

However book value is \$1.50/sh. at Dec. 31, 1978, based on number of shares outstanding. Thus warrant holders would be buying stock above book value and if they can be induced to do

so, full exercise of the Ser. B warrants would add another 12,886,000 sh. to the 3,289,000 sh. now out and boost book value to $1.88/sh.

C&S Realty is separating from its advisory relationship with the large Atlanta bank of the same name about the end of March and will go its separate way. The trust holds $135 million assets divided 53% properties held for investment, 19% foreclosed property held for resale, and 28% mortgage loans. About 33% is not earning income.

The liability structure is under control after a massive restructuring in 1978. C&SRI owes $76 million to banks, payable in quarterly installments ranging from $2.6 to $6.9 million from Sept. 1979 to Sept. 1982, when a $44 million balloon would become payable. Interest is accrued at 7% currently, so long as the sum of shareholders' equity and $4 million cancellable debt to the former adviser exceeds $10 million. The trust is to pay 1% interest in cash and issue noninterest bearing notes for any remainder. One key then is that this bank agreement puts an effective cap on shareholders' equity until bank debt is retired in 1982, or that continuing interest charges will drain the slim $5.7 million shareholders' equity along the way.

Other liabilities look manageable: $21 million mortgage debt secured by properties and $8.1 million of 3%-7% debentures exchanged in 1978 for an earlier debenture issue, now repaid in full.

The 3%-7% debentures are an interesting and attractive alternate to the warrants. They carry 3% interest through Sept. 30, 1982 and 7% afterward until maturity June 30, 1993. <u>They may be used at par</u> to exercise the Series B warrants. With the bonds trading at $60 currently (spreads may vary widely however) the price of 50 shares could effectively be lowered to $68 (i.e., one bond and one warrant), or $1.36/sh. vs. the $1.25 market price. That cuts the premium to a nominal 9% or so, making this package approach our favored route to playing C&SRI. FYI, a new name (possibly Southmont Properties) will be selected about the end of March.

<u>Colwell Mortgage Trust</u> new preferred with $7.50 liquidating value. Colwell emerged from a pre-approved Ch. XI bankruptcy action in April 1978 and succeeded in converting all subordinated debt into a maximum 2.15 million preferred shares, over 2.03 million common shares. The preferreds carry no dividend and are equal to common in all respects except for a $7.50/share preference in liquidation.

The preferreds are quoted at 2¼ bid, 2-3/4 asked while the common is 1-3/4 bid, 2-1/8 asked. This means the market is willing to pay about a 25-30% premium for the liquidation preference. For analytical purposes, we lump the preferred with common in figuring Colwell's book value, which works out to $2.74/sh. on a combined basis.

We think the preferred is moderately attractive as a speculation because the remaining $92 million bank debt is locked in at 8% interest until Dec. 31, 1984, giving the trust major protection against interest rates; because conversion of subordinated debt into preferred saves substantial extra interest costs; and because we doubt that the trust would be forced into a second bankruptcy. The flip side is that banks received pledge of substantially all trust assets in return for the interest rate lock-in, so that all assets could conceivably go to banks if liquidation doesn't proceed on plan.

<u>First Pennyslvania Mtg. Trust</u> 6-3/4% convertibles due 1991 now have a more realistic conversion price of $8.65/sh. as result of a 1978 settlement of a class action lawsuit by unhappy bondholders. With the stock selling at 1-7/8 (NYSE) and the bonds at about 50 (OTC), conversion parity

(i.e., the price at which the stock must sell to equal the bond price) is still a high 130% premium. Still, FPM has been making encouraging recent progress in recent quarters in swapping assets to banks at sizeable gains, letting the trust rebuild depleted book value. But FPM lost 87¢/sh. in the Jan. quarter even after some swap gains, reducing net book value to $1.63/sh. This is a thin margin and puts a heavy load on future success of asset swaps to make the bonds interesting as an equity play.

We also find interesting some of the straight bonds emerging from tender and exchange offers, again on the premise that the trusts and their underlying assets now have enough merit to keep the trusts from being pushed into a Chase-type corner. These bonds include the Bay Colony Prop. new 8½s of 89, priced to yield about 12% current income; the GMR Properties 8½s of 1987, priced at about 65 to yield 13% currently; and the Institutional Investors 8¼s of 1987, priced about 65 to yield 12% current income. All three emerged from recent tender offers that pushed out relatively near-term maturities of other subordinated debt, and all three are thus subject to the risk that the trust will be unable to meet maturities of the remaining debt.

Some idea of how real that risk may be comes from First Newport Realty whose 8-3/4% debentures mature May 15. The trust has received permission from senior banks to meet this maturity call provided it can generate funds from asset sales; so far the trust has been able to buy some debentures in the market at discounts from par (recent price is 93 bid) and it appears able to meet the maturity.

Near-term maturities of the three trusts which recently extended debt are: Bay Colony Prop., old 8½s are due March 31, 1981, or about two years; GMR Prop., 7.70s due Feb. 1, 1980, or less than one year; and Institutional Investors, the 7-7/8s also due Feb. 1, 1980, or less than one year. The latter two are trading about 91 and 90¼ respectively to give about 15-17% yield to maturity. If the First Newport pattern is followed, senior banks will allow them to repay the $5.1 million and $6.5 million respectively maturing in a year. You can follow these and the other securities mentioned above monthly through the straight bond and convertible bond tables in the REALTY TRUST REVIEW statistical issue.

A slightly different version of this risk is the First Virginia Mtg. 4s and variable rate (now 11½%) subordinated debentures. We still put them in the moderately interesting category although they are less attractive than the trio discussed above. Reason: both issues totaling $20 million mature Nov. 1, 1980, or about 18 months hence. But FVM also owes $23 million to its banks and says it is now discussing a master asset swap with them to repay all bank debt. Assuming the trust can surmount these hurdles, trustees have said they intend to seek a merger or other business combination for longer-term viability and use of the trust's $10.51/sh. taxloss carryforward. All this strikes us as a high hurdle, and so while we think the higher yield to maturity may appear good, risk also appears higher.

We also put the stock and/or bonds of several bankrupt trusts in this category, namely new Great Amer. Mgmt. & Inv. stocks and 3% senior subordinated notes; Dominion Mtg. & Rlty., Metroplex Realty, and potentially Guardian Mtg. stock. Existing subordinated debt of the latter three would be converted into stock under pending reorganization plans.

Crap shoots are security situations (not the entity itself) where events appear out of control of management and so we cannot make any rational appraisal of outcome. Securities in this group include NJB Prime Inv. and Chase Man. M&R, both hanging on uncertain outcome of bankruptcy actions; North Amer. Mtg., all securities pending outcome of its potential default on March 15 maturity of its subordinated debt.

## GROUP REVIEW: SHORT-TERM MORTGAGE TRUSTS: THERE'S NO BUSINESS LIKE NO BUSINESS

No other group of realty trusts is feeling competitive pressures more than the short-term mortgage trusts. Four of the 11 trusts in this grouping (see RTR, Feb. 23, p. 4 for group members) are pursuing mergers or considering liquidations.

The pressures became apparent almost a year ago when Nationwide Real Estate Investors halted making new commitments and began seeking a merger partner. NREI's careful cost analysis showed trustees that it was making only 0.1% on prime short-term construction loans, mainly because traditional money sources in banks and savings & loan associations were flush and willing to lend at low rates. As an intermediary, NREI had to borrow from banks and relend at a marked-up rate to cover its costs. This higher cost of money made it next to impossible to compete directly with banks (see RTR, April 14, 1978 for additional discussion).

Now this vanishing spread has compelled three other short-term lenders to look at liquidation or business combination. The box for each is that new loans add only marginally to trust earnings, if at all, while shareholders assume 100% of the risk of sour loans.

So with four of 11 members already looking around, the group of short-term mortgage lenders should be inspected closely by investors. We think there are some interesting values in stocks of trusts that haven't announced any alternative plans already. Keep in mind that all trusts briefly discussed here have remained qualified realty trusts, have very little taxloss carryforwards, and generally pay dividends. Thus they are not deeply troubled by bad loans but bedeviled by industry competitive conditions beyond which they have little control. Each in its way, with exception of Lomas & Nettleton Mortgage, is grappling with our poser: What do you do when there's no business like no business? Each is reviewed briefly here; refer to the Feb. 9, 1979 Relative Appeal Rankings for fact details.

Nationwide Real Estate Inv.'s proposed merger into Buckeye S&L came unglued this past week mainly because Buckeye stock had dropped in market price during the long period of working out merger details. Both headquarter in Columbus, O. and are still talking to find ways to overcome the market price obstacle. Buckeye stock jumped a bit to 15¼ bid on strength of merger offers for some West Coast S&Ls this week but still is well below the $22-24 range at which the merger was negotiated.

Merger failure could renew interest by other companies in Nationwide, whose competitive situation remains unchanged in the year. The shares at 13¼ bid OTC still hang 46% below a $24.36 book value believed reasonably solid. Worst case seems to be that trustees decide to liquidate and pay out book value to holders. We're moving up our No. 2 ranking to No. 1.

Sutro Mtg. Inv. Trust has begun negotiations with PNB Mtg. & Rlty., Philadelphia based long-term mortgage trust, to explore a share-for-share exchange. Statistically the deal seems to make sense: Sutro shares at 9-3/8 (NYSE) sell 40% below $15.59/sh. book value while PNB shares at 9-3/4 are 48% below $18.81 book value. So far there's no indication of how talks are going.

Hanover Square Realty Inv. in Jan. effectively halted new commitments and said it would repay bank borrowings as quickly as possible to restore profits. The trust may sell mortgages or loan participations, and may need to add to its allowance for losses to cover any discounts required. Trustees continue to review alternative opportunities for the trust "including but not limited to new business activity, sale or merger, or liquidation," they said.

Hanover Square is advised by the Pearce, Mayer & Greer mortgage banking subsidiary of W.R. Grace & Co. The stock at 6 (ASE) sells about 47% below

$11.27/sh. book value. The thinly traded stock is split among three large holders: W.R. Grace holds 12.7%, Stock broker Brent Baird holds directly and indirectly 8.2%, and CL Assets, a closed end investment company, 5.3%.

Baird & Warner Mtg & Rlty. trustees on Feb. 22 ordered management to prepare a liquidation plan for their consideration and submission to shareholders, if approved. They also suspended making new commitments for now.

This move may be only a ploy in a fight over control of the trust. New York City stock arbitrageur Carl Icahn has accumulated 25% of the stock and seeks to call a special meeting to vote on a new slate of trustees he intends to propose. Icahn has so far been silent on the trust's liquidation plan. B&W shares have moved up on the control fight, standing now at 10¼ bid or 35% below $15.85/sh. book value.

Nationwide RE appears the best buy to us because of the higher certainty that the trust will wind down or merge. Hanover Square is interesting but the fact that trustees caution about possible additions to the loss reserve gives us the impression that the discount from book value may be overstated. Baird & Warner's liquidation plan, if it passes muster with trustees and holders, could be attractive if liquidation time is short.

Beyond these mature situations, you may find better hunting among other members of the group, as follows:

Central Mtg. & Rlty. says it has reached a recovery stage where trustees may consider resuming dividends in the near future. One of two original mortgage banker sponsors recently gave up its stake in the adviser when it was acquired by a bank and the trust is now managed by a unit of mortgage banker Eberhardt Co. of Minneapolis. The stock trades at 6-3/4 bid (OTC) for a 50% discount from book value believed reasonably hard. The No. 2N-Ranked shares are an interesting buy.

First Continental REIT (8¼-OTC) is a Texas-based trust with mortgage banker sponsor. Portfolio is clean but trust appears near limits of leveraging capability. The 20% discount from $10.34 book value makes the No. 2-Ranked shares attractive mainly for income.

Fraser Mtg. (10-3/4-OTC) is Cleveland based and lends mostly in Ohio. It is conservatively managed and the 35% discount from book value is attractive in combination with the yield. Cleveland investor Jeffrey Schultz holds or advises about 17½% of shares, but has so far made no definite proposals.

Lomas & Nettleton Mtg. (16-7/8-NYSE) is king of this group and continues to generate new mortgages and earnings from its nationwide mortgage banking base. We have ranked shares No. 1 for the 39% discount from book value and good yield.

M&T Mortgage is a smaller Texas-based trust specializing in single-family construction loans. Problems never became high and the shares at 9-3/4 (OTC) provide good yield but only a 5% discount from book value.

Mortgage Trust of America (7-NYSE) is ranked No. 1N as a standout speculative value at 47% below book value. MTA has made spectacular progress in cutting problem loans and has lender okay to make new loans.

Western Mortgage Inv. (3-5/8-Boston) is among the smallest trusts in the group and sells at the steepest discount, 54% below book value. The trust is believed talking merger with other trusts and the No. 2N-Ranked shares have speculative potential.

## MERGERS & ACQUISITIONS: UMET TRUST TO YIELD CONTROL TO PRIVATE STORAGE COMPANY

UMET Trust (2-5/8-NYSE) says it will turn over control of its board to Robert I. Lynch, president of Perpetual Storage, Inc., Salt Lake City operator of underground storage facilities for microfilm and records. Perpetual has bought about 14% of UMET stock. UMET has been reporting continued losses.